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ORDER NO. 1427

UNITED STATES OF AMERICA
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Before Commissioners:

Ruth Y. Goldway, Chairman;
Nanci E. Langley, Vice Chairman;
Mark Acton;
Tony Hammond; and
Robert G. Taub

Annual Compliance Report, 2010

Docket No. ACR2010-R

ORDER ON REMAND

(Issued August 9, 2012)

I. INTRODUCTION

On April 17, 2012, the United States Court of Appeals for the District of Columbia Circuit issued an opinion in *United States Postal Service v. Postal Regulatory Commission,* 676 F.3d 1105 (D.C. Cir. 2012) granting a limited aspect of the Postal Service's petition for review of the Commission's Annual Compliance Determination (ACD) for Fiscal Year 2010.[1] The Court remanded the case to the Commission "for a definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity…." 676 F.3d at 1109. This Order responds to the Court's Opinion.

[1] Docket No. ACR2010, Annual Compliance Determination, March 29, 2011 (FY2010 ACD).

This proceeding grows out of the Postal Service's filing of its Annual Compliance Report (ACR) for FY 2010.[2] Upon receipt of this report, the Commission was required to make a written determination, or ACD, within 90 days "as to—(1) whether any rates or fees in effect during such year (for products individually or collectively) were not in compliance with applicable provisions of this chapter…; or (2) whether any service standards in effect during such year were not met." 39 U.S.C. § 3653(b)(1) and (b)(2).

On March 29, 2011, the Commission issued its FY2010 ACD. Among its conclusions was a finding that the rates for the product Standard Mail Flats were in violation of 39 U.S.C. § 101(d). FY2010 ACD at 106. That section requires that "[p]ostal rates shall be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." Acting pursuant to 39 U.S.C. § 3653(c), the Commission directed the Postal Service "to increase the cost coverage of the Standard Mail Flats product through a combination of above-average price adjustments…and cost reductions until such time that the revenues for this product exceed attributable costs." *Id.*

II. THE COURT'S OPINION

On appeal, the Postal Service argued that by relying upon the mandate in section 101(d), the Commission had improperly looked beyond the criteria prescribed by 39 U.S.C. § 3622(c) for market dominant products, which include Standard Mail Flats. 676 F.3d at 1107. The Postal Service also argued that the Commission's determination was arbitrary and capricious. *Id.*

The Court rejected the Postal Service's first contention and upheld the Commission's finding that section 3622(c)(14), which governs market dominant products, permits the Commission to consider the general standards of section 101(d)

[2] United States Postal Service 2010 Annual Compliance Report, December 29, 2010 (FY2010 ACR). The filing of an ACR is required by 39 U.S.C. § 3652.

in an annual compliance determination, "at least in extreme circumstances." *Id.* at 1108.

In response to the Postal Service's claim that the remedy prescribed by the Commission was arbitrary and capricious, the Court questioned whether the Commission's treatment of Standard Mail Flats was consistent with its treatment of other market dominant products having comparable, or lower, cost coverages. *Id.* The Court also questioned whether the remedy imposed by the Commission on Standard Mail Flats would continue to be appropriate if its attributable cost coverage were to improve. *Id.* ("Why might not Standard Flats cease to be an extreme case at some slightly-less-than-complete cost coverage number…."). The Court therefore remanded the case to the Commission "for an explanation of the relation between its remedy, on one hand, and its treatment of other products and indeed the bounds of its authority, on the other." *Id.* at 1106-07.

On June 12, 2012, the Court issued its mandate remanding the case to the Commission "for a definition of the circumstances that trigger § 101(d)'s failsafe protection, and for an explanation of why the particular remedy imposed here is appropriate to ameliorate that extremity, in accordance with the opinion of the court filed herein."[3]

III. CIRCUMSTANCES THAT TRIGGER SECTION 101(d)

The Commission's first task on remand is to provide "a definition of the circumstances that trigger § 101(d)'s failsafe protection…." *Id.* Consideration of this task must begin with a recognition of the requirements in section 101(d). Among the principal policies of the Postal Reorganization Act (the Act), as amended, is the policy

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[3] The remand requires the Commission to explain more fully the reasoning behind its treatment of Standard Mail Flats in the FY2010 ACD. As such, this remand proceeding does not require the solicitation of comments or views from the Postal Service or other interested persons for the Commission to be able to comply with the Court's directives.

expressed in section 101(d) that rates reflect a fair and equitable apportionment of costs of all postal operations to all users of the mail. Rates that do not cover a product's attributable costs, *i.e.,* volume variable costs plus any product-specific costs, are subject to more careful scrutiny by the Commission because, among other things, any shortfall shifts burdens onto other mailers.

In principle, it is fair and equitable for products to recover their attributable costs. That conclusion, however, does not mean that any time rates for a product fail to cover attributable costs the Commission will automatically, pursuant to 39 U.S.C. § 3653, find the Postal Service out of compliance and order remedial action. The totality of circumstances presented is critical to Commission evaluations under section 3653. For example, did costs unexpectedly spike during the preceding year? Has the situation persisted for some time? If so, what remedial steps has the Postal Service taken?

A. Background

In the proceedings leading up to the FY2010 ACD and in the FY2010 ACD itself, the Commission discussed factors that can trigger application of the "fair and equitable" cost apportionment requirement of section 101(d).

The first Commission opportunity to consider a Postal Service ACR was the proceeding that reviewed Postal Service results for FY 2007 (the 2007 ACR proceeding).[4] In its FY2007 ACD, the Commission concluded that, as a class, Standard Mail had a 158 percent cost coverage. *Id.* at 87. What that meant was that revenues for the entire Standard Mail class were 158 percent of Standard Mail's "attributable costs."[5] All revenues in excess of 100 percent of attributable costs for the Standard Mail class (*i.e.,* an additional 58 percent of attributable costs) were available in FY 2007

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[4] Chairman's Message at 1 as contained in Docket No. ACR2007 Annual Compliance Determination, March 27, 2008 (FY2007 ACD).

[5] Attributable costs are, in general, those costs that vary with changes in volume or, though fixed, are specific to a class of mail or type of mail service.

to meet the Postal Service's "institutional costs".[6] In other words, in FY 2007, the Standard Mail class generated revenues that met all of the costs attributable to the products included in the Standard Mail class, leaving additional revenues to cover the Postal Service's institutional costs. The Commission was, however, unable to analyze pricing relationships within the Standard Mail class because "[t]he Postal Service did not submit data that were aligned with the new product designations…." *Id.*[7] None of the commenters in the 2007 ACR proceeding addressed the lack of financial data at the product level. FY2007 ACD at 87.

In the FY2008 ACR proceeding, the Postal Service was able for the first time to provide financial data aligned with its new product designations.[8] As a class, Standard Mail's cost coverage was 156 percent. *Id.* at 59. Cost coverage for Standard Mail Letters, a product within the Standard Mail class, was 194 percent. In contrast, the cost coverage for Standard Mail Flats, a different Standard Mail product, was only 94 percent, which translated to a loss of 2.2 cents per piece for each Standard Mail Flat processed by the Postal Service. *Id.* at 60. The total loss for Standard Mail Flats was $218 million, or approximately 20 percent of the Postal Service's $1.2 billion loss from products with a negative contribution during FY 2008. *Id.* at 61.

In its FY2008 ACD, the Commission concluded that revenues for Standard Mail Flats failed to satisfy 39 U.S.C. § 3622(c)(2), and that the lack of sufficiently high cost coverage might be inconsistent with 39 U.S.C. § 101(d) and 39 U.S.C. § 3622(b)(5). *Id.* The Commission noted further that in its most recent market dominant rate adjustment in Docket No. R2008-1, the Postal Service had proposed below-average increases for Standard Mail Flats and above-average increases for Standard Mail Letters thereby

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[6] Institutional costs are those costs that remain after the determination of attributable costs, *i.e.,* total costs minus attributable costs.

[7] The new product designations were the product designations established following enactment of the Postal Accountability and Enhancement Act (PAEA), Pub L. 109-435, 120 Stat. 3198 (2006).

[8] Docket No. ACR2008, Annual Compliance Determination, March 30, 2009, at 60 (FY2008 ACD).

placing a disproportionate and increasing share of the burden of institutional costs on mailers of Standard Mail Letters.[9] The Commission responded by directing the Postal Service to either decrease the disparity between letters and flats in future rate increases or "provide the Commission with empirical evidence that the market characteristics of letters and flats or other non-cost factors justify the unequal treatment." FY2008 ACD at 62 (emphasis omitted).

In its subsequent FY2009 ACD, the Commission noted that, notwithstanding its admonition in the FY2008 ACD, the Postal Service had once again implemented a below-average price increase for Standard Mail Flats which failed to keep pace with an increase in unit attributable costs for flats.[10] This below-average increase did not decrease the disparity between letters and flats. Nor had the Postal Service provided empirical evidence to justify the unequal treatment of Standard Mail Letters and Flats. *Id.* The disparity between Standard Mail Letters and Flats simply increased without justification or explanation.

In FY 2009, cost coverage for Standard Mail Letters was 174 percent, yielding a contribution to institutional cost of 8.1 cents per letter. *Id.* at 84-85. By contrast, cost coverage for Standard Mail Flats declined from 94 percent in FY 2008 to 82 percent in FY 2009. *Id.* at 85. This produced a loss in FY 2009 of 7.9 cents per piece for Standard Mail Flats. *Id.* Between FY 2008 and FY 2009, the loss per piece for Standard Mail Flats increased from 2.2 cents to 7.9 cents. The disparity in contribution between Standard Mail Letters and Standard Mail Flats increased from approximately 11 cents per piece in FY 2008 to over 18 cents in FY 2009. *Id.* at 86. The total

[9] Docket No. R2008-1, United States Postal Service Notice of Market-Dominant Price Adjustment, February 11, 2008 (Docket No. R2008-1, Notice). The overall increase for the Standard Mail class was 2.875 percent. *Id.* at 5. A below-average increase of 0.86 percent was applied to Standard Mail Flats. *Id.* at 15. An above-average increase of 3.39 percent was applied to Standard Mail Letters. *Id.*

[10] Docket No. ACR2009, Annual Compliance Determination, March 29, 2010, at 86 (FY2009 ACD). The May 2009 price increase for Standard Mail Flats was 2.294 percent, whereas the increase in unit attributable costs for flats was approximately 15 percent. *Id.*

FY 2009 loss for Standard Mail Flats more than doubled to approximately $616 million, which was more than 35 percent of the $1.7 billion in losses from products with negative contributions. *Id.* at 28.

Although the Commission did not find the rates for Standard Mail Flats to be out of compliance in the FY2009 ACD, the Commission found that the appropriate action was for the Postal Service to devise a plan to improve cost coverage of the Standard Mail Flats. *Id.* at 86-87. The plan was to include any operational or mail preparation changes deemed necessary, as well as a specific timeline for achieving a positive contribution from Standard Mail Flats. *Id.* at 87. The plan was to be included in the earlier of the FY2010 ACR or the next general market dominant rate adjustment. *Id.*

The Postal Service's first response to the FY2008 and FY2009 ACDs came in a proposal to increase Standard Mail Flats' cost coverage as part of its exigent rate request in Docket No. R2010-4.[11] The Commission denied the exigent rate request without ruling on the propriety of the specific rate proposal for Standard Mail Flats.[12]

Following the denial of its exigent rate request, the Postal Service made no further proposals to improve the cost coverage of Standard Mail Flats. Nor did the Postal Service provide a justification for failing to take such steps. Instead, in its FY2010 ACR, the Postal Service suggested that the Commission should "determine whether it can exercise any of its powers to remedy the cost coverage shortfall of the products in question."[13] FY2010 ACR at 9. The Commission rejected this attempt by the Postal Service to avoid its responsibility for addressing the Standard Mail Flats' cost coverage shortfall and noted that the Postal Service has "sufficient operational and

[11] Docket No. R2010-4, Exigent Request of the United States Postal Service, July 6, 2010.

[12] Docket No. R2010-4, Order Denying Request for Exigent Rate Adjustments, September 30, 2010, at 3 (Order No. 547). The exigent rate request was denied because the Postal Service had failed to demonstrate that the proposed rate adjustments were "designed to respond to the recent recession, or its impact on mail volume." *Id.*

[13] Docket No. ACR2010, Annual Compliance Determination, December 10, 2010 (FY2010 ACD).

pricing flexibility to allow it to accomplish its long-term goals for Standard Mail Flats as advanced in Docket No. R2010-4 [the exigent request proceeding]." *Id.* at 106. As an example of such pricing flexibility, the Commission cited the Postal Service's price adjustment proposal in Docket No. R2011-2 that had been designed to reduce the cost coverage shortfall for the Standard Not Flat-Machinable (NFMs)/Parcels product, another Standard Mail product.[14]

As a result of the Postal Service's inaction, the rates for Standard Mail Flats in effect during FY 2010 produced a substantial and growing cost coverage shortfall that burdened mailers of other Standard Mail products. FY2010 ACD at 106. As reported by the Postal Service in its FY2010 ACR, the cost coverage for Standard Mail Flats in FY 2010 had fallen to 81.6 percent. FY2010 ACR at 31. Both commercial flats and nonprofit flats contributed to that cost coverage shortfall. *Id.* at 103-04, Figure VII-3. As cost coverage declined, the revenue lost by the Postal Service on every piece grew. Between FY 2008, the first year in which the contribution of the Flats' product was reported, and FY 2010, the negative contribution per piece grew by 279 percent from a loss of 2.2 cents per piece to a loss of 8.3 cents per piece. *Id.* at 106, Table VII-17. From FY 2008 through FY 2010, Standard Mail Flats' failure to cover attributable costs produced a cumulative loss of $1.4 billion. FY2010 ACD at 106. The Commission concluded that the prices in effect in FY 2010 for Standard Mail Flats did not comply with section 101(d) and found that the $1.4 billion loss "reflects an unfair and inequitable apportionment of the costs of postal operations to all Standard Mail users." *Id.*

B. Factors Relevant to Section 101(d) Analysis

Section 101(d) requires that postal rates "be established to apportion the costs of all postal operations to all users of the mail on a fair and equitable basis." The "fair and equitable" standard in section 101(d) is not defined in title 39, nor is that standard self-

[14] Docket No. R2011-2, United States Postal Service Notice of Market-Dominant Price Adjustment, January 13, 2011 (Docket No R2011-2, Notice).

defining. Rather, the fair and equitable standard is, like standards in other Federal regulatory statutes, a flexible standard that is given content by consideration of all relevant factors.[15]

From its review of Standard Mail Flats in the FY2007, FY2008, FY2009, and FY2010 ACDs, the Commission identified the following factors which, together, constituted circumstances that triggered section 101(d)'s failsafe protections: a significant and growing cost coverage shortfall; duration of the shortfall over a significant period; evidence that the cost coverage shortfall was likely to increase further; a significant adverse impact on users of other mail products (some of whom could be competitors of mailers of the subsidized mail product) requiring subsidization of the non-complying product; failure of the Postal Service to address the shortfall by rate increases, cost decreases, or a combination thereof, despite the capability to do so; and failure of the Postal Service to provide an adequate explanation for not taking necessary remedial steps designed to ameliorate the cost coverage shortfall. Together, these factors were characterized by the Commission in its appellate brief as an "extreme case". 676 F.3d at 1107 (*citing* Respondent's Brief at 29).

While the factors presented in the FY2010 ACR constituted "extreme circumstances" authorizing Commission action under § 101(d), variants of those factors could also trigger the protections of section 101(d). Moreover, other factors not present in the FY2010 ACR, could emerge to support a conclusion that an extreme case requiring action under section 101(d) existed.

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[15] *See National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810, 825-26 (1983) ("Generally, the legislature leaves to the ratesetting agency the choice of methods by which to perform this allocation…although if the statute provides a formula, the agency is bound to follow it."); s*ee also Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581, 589 (1945); and *Whitman v. American Trucking Associations, Inc*., 531 U.S. 457, 474-76 (2001). Other examples of broadly formulated regulatory standards include "just and reasonable", "public interest, convenience or necessity", and "unfair methods of competition." *Yakus v. United States*, 321 U.S. 414, 427 (1944).

On the other hand, the finding of an "extreme case" would not be justified, if, for example, the Postal Service had not yet had a reasonable opportunity to remedy the shortfall. Similarly, if the Postal Service were to demonstrate that price increases would be counterproductive under the statutory price cap or that cost reductions were not feasible, an "extreme case" authorizing action under section 101(d) might not exist.

In short, while circumstances justifying invocation of section 101(d) may vary, in making any such determination, the Commission considers the totality of the circumstances presented, and, as in the instant case (*see* page 9, *supra*), determines whether rates for a product were or were not in compliance with the applicable provisions of 39 U.S.C. chapter 36 based on a preponderance of relevant factors. Such circumstances must be determined on a case-by-case basis by evaluating all relevant factors. In its FY2010 ACD, the Commission identified factors which it concluded were relevant and supportive of action under section 101(d). Together, the totality and preponderance of relevant factors define circumstances that trigger section 101(d). Their identification does not, however, preclude the conclusion that other combinations of those, or other, relevant factors may authorize action under section 101(d).

IV. APPROPRIATENESS OF THE REMEDY

The Commission's second task on remand is to explain why the remedy it imposed in the FY2010 ACD is appropriate. 676 F.3d at 1108. Before addressing this subject, it is useful to summarize both the remedy imposed by the Commission and the Court's response to that remedy.

In its FY2010 ACD, the Commission required the Postal Service "to increase the cost coverage of the Standard Mail Flats product through a combination of above-average price adjustments, consistent with the price cap requirements, and cost reductions until such time that the revenues for this product exceed attributable costs." FY2010 ACD at 106. The Commission stated that increases above the class average would be necessary and should be accompanied by efforts to streamline operations to capture efficiencies and reduce costs. *Id.* at 107. The need for, and importance of, cost controls was evident from the fact that attributable costs of Standard Mail Flats had increased by 15 percent on a per-piece basis since FY 2008, whereas the Consumer Price Index for All Urban Consumers (CPI-U) had only increased by approximately 1 percent over this same period. *Id.*

While the Commission did not impose a specific deadline, it did direct the Postal Service to "move as promptly as practicable to eliminate this inequity" and to begin this process with the Postal Service's next market dominant price adjustment. *Id*. The Commission also directed the Postal Service to prepare a schedule of above-CPI planned price increases. *Id.*[16] The planned steps for eliminating the intra-class cross subsidy created by Standard Mail Flats were to be the subject of reports in future ACRs and notices of market dominant price adjustments. FY2010 ACD at 107.

The Court read the Commission's statement that cost coverage of the Standard Mail Flats product be increased "until such time that the revenues for this product exceed attributable costs" as implying that "only 100% cost coverage, and nothing short of 100%, would bring Standard Flats into compliance with § 101(d)." 676 F.3d at 1108. The Court suggested that such a requirement might be inconsistent with the Commission's treatment of other market dominant products, several of which have even lower cost coverages. *Id.* The Court also questioned whether, at some level of cost coverage below 100 percent, Standard Mail Flats might no longer present an extreme case. *Id.*

[16] This latter requirement was subsequently stayed pending resolution of the Postal Service's appeal of the FY2010 ACD. Docket No. ACR2010, Order Granting Stay, May 27, 2011 (Order No. 739). The stay granted by Order No. 739 expressly applied only to the requirement that a schedule of above-CPI rate increases for Standard Mail Flats be filed and did not apply to the general remedial action established in the FY2010 ACD. *Id.* at 2.

A. The Commission Remedy was Appropriate in this Case

In orders leading up to the issuance of the FY2010 ACD, the Commission had expressly raised the possibility that Standard Mail Flats' long-running failure to recover out-of-pocket costs could be in violation of section 101(d)'s requirement that the costs of postal operations be apportioned on a fair and equitable basis. *See supra* at 5-7. In the FY2010 ACR proceeding, several parties argued that on the facts presented such a violation was occurring. FY2010 ACD at 106.

The fairness and equity of cost apportionment required by section 101(d) clearly encompasses consideration of each product's cost coverage and whether reasonable steps are being taken to resolve any apparent problems with product cost coverage. Unless a product covers its attributable costs, the burden of recovering those costs, as well as the contribution needed to cover the Postal Service's institutional costs, will fall on users of other mail products.[17] As the magnitude of the cross-subsidization of users of one mail product by users of other mail products grows, such cross-subsidization directly implicates the fair and equitable standard of section 101(d).

In this case, the cost coverage deficiency of Standard Mail Flats results in a continuing and growing contribution shortfall and the subsidization of Standard Mail Flats by other Standard Mail customers. By the time of the FY2010 ACR, the Commission determined that the magnitude ($1.4 billion) and duration (over 3 years) of such shortfall and subsidization required either ameliorative steps to eliminate the shortfall and subsidies by improving cost coverage, or an explanation justifying the failure to take ameliorative steps. The Postal Service failed to attempt to do either. Thus, there existed the preponderance of factors, outlined in section III.B., above, that led the Commission to conclude the intra-class cross subsidy violated section 101(d)'s requirement that costs be apportioned on a fair and equitable basis.

[17] For market dominant products, the law identifies 9 objectives and 14 factors that the Postal Service must balance when setting prices. *See* 39 U.S.C. §§ 3622 (b) and (c).

Against this backdrop, the Commission devised a remedy to achieve compliance with section 101(d) over time. The Commission's remedy directly addresses the reason for non-compliance of Standard Mail Flats with section 101(d), namely, the growing negative contribution (loss); the increasing disparity with Standard Mail Letters; and a failure by the Postal Service to remedy the problem. The Commission did not attempt to dictate the specific means by which costs should be covered, or the date by which complete cost coverage must be achieved. Instead, what the Commission did was require the Postal Service to focus its attention on resolving this continuing problem and to develop and implement a plan for increasing cost coverage "through a combination of above-average price adjustments, consistent with the price cap requirements, and cost reductions until such time that the revenues for this product [*i.e.,* Standard Mail Flats] exceed attributable costs." *Id.* In taking these steps, the Commission afforded the Postal Service an opportunity to tailor appropriate remedial actions under section 101(d)'s "fair and equitable" standard to the specific circumstances of Standard Mail Flats.

B. Cost Coverage and the Fair and Equitable Apportionment of Costs

In its Opinion, the Court questions whether Standard Mail Flats might "cease to be an extreme case at some slightly-less-than complete cost coverage number (Would 95% suffice? What about 99%)." 676 F.3d at 1108.

The short answer to this question is "yes", provided the Postal Service has either taken adequate steps toward the elimination of the shortfall or presented adequate reasons to explain the shortfall.[18]

In economic terms, an enterprise such as the Postal Service cannot remain viable if it does not cover its attributable costs over the long term. While situations may

[18] This conclusion is evident from previous ACDs where products that failed to recover attributable costs were not found out of compliance following discussion of relevant circumstances.

arise that prevent any particular product from doing so, and the law gives the Postal Service considerable pricing flexibility within the price cap, the consequences of such a shortfall must be regularly assessed based on the circumstances presented.

ACDs involve a *post hoc* review of the Postal Service's prior fiscal year results, including, where relevant, remedial rate actions proposed or taken. In the matter at hand, the Postal Service has the right to explain whether, and at what point, increased cost coverage for Standard Mail Flats might become infeasible or undesirable in light of the statutory cap and other statutory considerations. The Commission does not interpret section 101(d) to require "only 100% cost coverage, and nothing short of 100%," to satisfy the fair and equitable cost apportionment standard, provided an adequate explanation for a failure to improve cost coverages is offered. *Cf.* 676 F.3d at 1108. As the Commission stated in the FY2010 ACD, a finding that a product or class fails to satisfy a provision of title 39, including the cost coverage factor of 39 U.S.C. § 3622(c)(2), does not compel a finding of noncompliance. FY2010 ACD at 17. As noted, the Commission afforded the Postal Service the opportunity to design appropriate remedial actions that satisfy section 101(d)'s "fair and equitable" standard under the specific circumstances of Standard Mail Flats.

C. Consistency of the Treatment of Market Dominant Products

The Court observes that the FY2010 ACD identified two products—NFMs/Parcels and Periodicals—with even lower attributable cost coverages than Standard Mail Flats as reported in the FY2010 ACD. 676 F.3d at 1108. The cost coverage for NFMs/Parcels was 78 percent, and the cost coverage of Periodicals was 75.5 percent. *Id.*

Notwithstanding these differences, the Commission's treatment of Standard Mail Flats in the FY2010 ACD is not inconsistent with its treatment of NFMs/Parcels and Periodicals. Rather, the differences in cost coverages cited by the Court reflect differences in each product's history and circumstances, including the remedial steps taken to address each product's cost coverage shortfall.

1. NFMs/Parcels

The separate classification of NFMs/Parcels is relatively new. It was first approved by the Commission in its February 26, 2007 decision in Docket No. R2006-1, the last litigated general rate proceeding prior to enactment of the PAEA.[19] At the time the NFM rate category was created, the Commission acknowledged that this new category was "troublesome" because of the lack of cost data or reliable volume estimates broken down by mail mix. *Id.* at 229. The Commission nevertheless found that creation of the category on the basis of less than perfect data was appropriate in the hope that better data would become available later. *Id.* at 229-30.

It was not until the Commission's FY2008 ACR that sufficient information became available to assess the cost coverage of NFMs/Parcels. In that proceeding, the Commission found that NFMs/Parcels lost $166 million in FY 2008. FY2008 ACD at 62. By the time the Commission made that finding, the Postal Service had already proposed a 9.7 percent rate increase for NFMs/Parcels. Docket No. R2008-1, Notice at 15. That increase was well above the 2.838 percent increase for Standard Mail as a whole. FY2008 ACD at 62.

Shortly before issuance of the Commission's FY2009 ACD, the Postal Service proposed a further 16.425 percent rate increase for NFMs/Parcels in Docket No. R2009-2.[20] An additional rate increase of 11.346 percent was subsequently proposed as part of its FY 2011 market dominant price adjustment in Docket No. R2011-2. In both of these cases, the increases proposed for NFMs/Parcels were significantly above

[19] Docket No. R2006-1, Opinion and Recommended Decision, Postal Rate and Fee Changes, February 26, 2007 (PRC Op. R2006-1).

[20] Docket No. R2009-2, United States Postal Service Notice of Market-Dominant Price Adjustment, February 10, 2009, at 14, Table 7 (Docket No. R2009-2, Notice).

the percentage increase for the Standard Mail class as a whole.[21] The Commission has supported this continued "phasing-in" of rate increases (FY2008 ACD at 62) and has urged the Postal Service to adopt a plan with a timeline for improving cost coverage which includes operational or mail preparation changes. *Id.*; FY2009 ACD at 87; FY2010 ACD at 107-08. In its FY2010 ACD, the Commission also noted its conditional approval in Docket No. MC2010-36 of the transfer of certain Standard Mail Parcels to the competitive product list. FY2010 ACD at 108.[22] Overall, the Commission has encouraged the Postal Service to continue its efforts to "eliminate the intra-class cross subsidy for this product." *Id.*

The Commission has taken a measured approach under 39 U.S.C. § 3653(c) which permits the Commission to consider a range of remedies. In the case of NFMs/Parcels, the Commission recognized the steps the Postal Service was taking and did not find the rates for this product out of compliance with section 101(d). *See, e.g.,* FY2009 ACD at 16.

2. Periodicals

Unlike the cost coverage shortfall for Standard Mail Flats, the cost coverage shortfall for Periodicals has been a long-standing problem that predates passage of the PAEA. Recognizing that fact, section 708 of the PAEA directed the Postal Service and the Commission, *inter alia*, to study and report on the quality of costing data, opportunities for improving efficiencies, including appropriate pricing incentives, and

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[21] *See* Docket No. R2009-2, Notice at 14, Table 7; Docket No. R2011-2, Notice at 16, Table 7.

[22] The Postal Service has the additional flexibility of pricing competitive mail without respect to the CPI cap.

recommendations for administrative or legislative action.[23] This study has provided a backdrop for intervening attempts to deal with the Periodicals cost coverage shortfall.

In its Opinion in the last rate proceeding under the PAEA's predecessor, the Postal Reorganization Act,[24] in Docket No. R2006-1, the Commission recommended a new rate structure that it believed would increase efficiencies and reduce the costs of Periodicals overall. PRC Op. R2006-1 at 300-01. To implement that recommendation, the Postal Service found it necessary to adopt important changes in its cost models, changes needed for the Commission to perform its ACD analysis.[25]

Although the attributable costs of Periodicals clearly exceeded revenues in FY 2007, the Commission concluded that the rate structure changes approved in Docket No. R2006-1 coupled with the proposed rate increase for Periodicals in Docket No. R2008-1[26] should be given additional time to overcome the unfavorable revenue-cost relationship that Periodicals had exhibited. FY2007 ACD at 70.

In succeeding ACR proceedings, Periodicals continued to yield cost coverage shortfalls. In FY 2008, cost coverage improved by approximately 1 percent, but still fell considerably short of full cost coverage. FY2008 ACD at 56. Moreover, the fact that Periodicals has only two products (Within County and Outside County Periodicals), neither of which covered its attributable costs, limits the opportunity for the Postal Service to improve attributable cost coverage by means of price increases while remaining within the Periodicals class price cap. *Id.* The Commission directed the

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[23] A Joint Task Force with representatives from both the Postal Service and the Commission was established to address the subjects mandated by § 708. A final report was issued during September 2011 approximately, 6 months after issuance of the FY2010 ACD. Periodicals Mail Study: Joint Report of the United States Postal Service and Postal Regulatory Commission, September, 2011.

[24] Pub L. 91-375, 84 Stat. 719, 39 U.S.C. §§ 101 *et seq.*

[25] The Commission approved a number of these cost model changes in the FY2007 ACD. FY2007 ACD at 70-82.

[26] Docket No. R2008-1, Notice at 17.

Postal Service to focus on cost control and improved pricing signals in order to improve cost coverage for Outside County Periodicals. *Id.*

In the FY2009 ACR, all commenters recognized that cost coverage had been a persistent problem for an extended period. None, however, suggested that rates be increased immediately to satisfy section 3622(c)(2). FY2009 ACD at 75. After considering available options, the Commission decided to await the issuance of the report by the Joint Task Force before addressing Periodical rates in specific detail. *Id.* The Commission did, however, direct the Postal Service to present a plan for increasing cost coverage. *Id.*

In FY 2010, cost coverage for Periodicals continued to deteriorate. FY2010 ACD at 91. Cost coverage for the entire class dropped from 76.05 percent to 75.46 percent. *Compare* 2009 ACD at 74, Table VII-4, *with* 2010 ACD at 91, Table VII-4. Both products within the Periodicals Class—Within County Periodicals and Outside County Periodicals—experienced a decline in cost coverage that contributed to the substantial cost coverage shortfall of the class. *Id.*

Because of the special situation presented by the Periodicals class, one commenter urged the Commission to find that the Postal Service's pricing policies violate section 101(d) and that Periodicals prices should be increased substantially above the statutory cap. FY2010 ACD at 91, 94.[27] The Commission concluded that because 96 percent of class revenues are provided by Outside County Periodicals, the Postal Service does not have the same flexibility to set prices substantially above the price cap as it does with respect to products within Standard Mail. FY2010 ACD at 94. This limit on corrective pricing measures led the Commission to direct the Postal Service to focus on cost reduction measures, including potential cost reductions detailed in the then-forthcoming Periodicals Study Report. *Id.* The Commission also

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[27] Docket No. ACR2010, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Initial Comments on the United States Postal Service FY 2010 Annual Compliance Report, February 2, 201[1], at 32.

suggested improvement in worksharing discounts and the prices for bundles and containers in an effort to provide mailers with incentives to prepare mail more efficiently. *Id.*

3. Differences in Treatment are Justified by Differences in Circumstances

All three products—Standard Mail Flats, NFMs/Parcels, and Periodicals—have presented significant cost coverage shortfalls over the past several years. Over this period, the Commission has urged the Postal Service to take steps to improve each product's cost coverage. As discussed above, each of the products has a different history. The differences in those histories explain the different level of cost coverage achieved by each and the different responses the Commission has taken.

The Commission's measured approach has sought to foster the Postal Service attempts to improve cost coverage, in each instance. With respect to NFMs/Parcels and Periodicals, the Postal Service has taken actions to address cost coverage issues.

In the case of NFMs/Parcels, the Postal Service has responded to cost coverage shortfalls by proposing above-average rate increases and the transfer of mail into competitive products that allow additional pricing flexibility. The Commission has supported this phasing-in approach.

In the case of Periodicals, the Postal Service faces a long-standing situation different than the one presented by Standard Mail Flats. As the Court itself recognized, the pricing of Periodicals is subject to special pricing limitations. 676 F.3d at 1108. Moreover, Periodicals, as a class, and both of the Periodicals products fail to cover costs, thereby limiting the opportunity for achieving full cost coverage by price increases within the price cap for the Periodicals class. To the extent permitted by the constraints of that price cap, the Postal Service has increased prices. Moreover, improved cost coverage is still being pursued by means of cost reductions, modifications of cost models, and improvements in mail processing efficiencies. As part of the overall effort, the Postal Service has also participated jointly with the Commission in the study mandated by section 708 of the PAEA to find ways of reducing the costs of handling Periodicals, and thereby improving Periodical cost coverages.

While NFMs/Parcels and Periodicals still suffered from cost coverage shortfalls, the record demonstrates the Postal Service has attempted to meaningfully address the cost coverage issues for these products consistent with the existing pricing structure.

By contrast, in the case of Standard Mail Flats, the Postal Service failed to take remedial action notwithstanding repeated Commission admonitions that steps need to be taken to address the cost coverage shortfall. The Postal Service's failure to address the continuing intra-class cross subsidy caused other Standard Mail users to complain about the rate preference accorded mailers of Standard Mail Flats, *i.e.,* an inequitable distribution of burdens compelling them to subsidize others' mailings. As noted, in this instance, the shortfall was significant, growing, longstanding, expected to increase, creating significant adverse impact on others, and had not been addressed or explained by the Postal Service. The Commission responded by directing the Postal Service to devise a plan to increase Standard Mail Flats revenues or decrease its costs so as to eliminate this problem. Under the circumstances, this action was entirely appropriate.

By the Commission.

Shoshana M. Grove
Secretary